United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-2128

ORIGINAL

To be argued by
ABRAHAM KAPLAN

In The

United States Court of Appeals

For The Second Circuit

In the Matter of
MADERO SILKS, INC.,

Bankrupt,

PAULINE GREEN,

Claimant-Appellant,

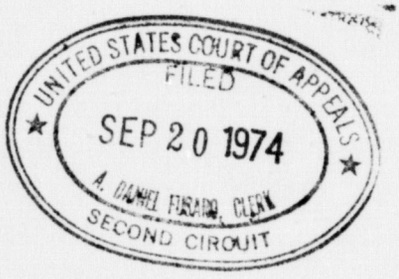
-against-

MARY JOHNSON LOWE,

Trustee-Appellee.

On Appeal from the United States District Court for the Southern District of New York

APPELLANT'S BRIEF AND APPENDIX



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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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In the Matter of

MADERO SILKS, INC., In Bankruptcy
No. 69 B 149

Bankrupt

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PAULINE GREEN,

Claimant-Appellant,

- against -

MARY JOHNSON LOWE,

Trustee-Appellee

----------x

APPELLANT'S BRIEF

Claimant appeals from the Order of the District Court (Motley,D.J.) dated June 28, 1974, entered July 2, 1974, which affirmed the decision and order of Hon. Edward J. Ryan, Bankruptcy Referee, dated October 31, 1973, expunging her claim in the sum of $17,000. against the bankrupt herein.

STATEMENT OF ISSUE PRESENTED

The issue presented by this appeal is whether a claim based on a loan made in the Tenth year of the corporate bankrupt's existence was properly expunged by the Bankruptcy Referee when he found that the loan was not actually made by the claimant, but made in claimant's name by the person controlling the corporation.

STATEMENT OF CASE

On February 27, 1969, an involuntary petition in bankruptcy was filed against Madero Silks, Inc., Bankrupt herein. In August, 1969, Pauline Green, Claimant herein, filed a Proof of Debt and Power of Attorney, claiming that the bankrupt was

indebted to her in the sum of $17,000. for moneys lent to the bankrupt on or about July 16, 1968. Subsequently, by Notice of Motion dated April 19, 1971, the Trustee moved for an Order expunging this claim on the ground that the same does not constitute a valid claim against the bankrupt estate, contending among other things that the "claim" should be deemed additional paid-in capital, or, in any event, subordinated to the claims of general unsecured creditors. Claimant's answer denied the allegations of the Trustee's petition and alleged affirmative defense of laches.

As the Trustee's motion followed testimony concerning the claim adduced at hearings between May 9, 1969 and July 30, 1969, under Section 21-a of the Bankruptcy Act, the respective attorneys entered into a stipulation as to the facts and the evidence to be deemed before the Court, and that further hearings before the Referee be waived, authorizing the Referee to decide the issue raised by the motion on the transcripts of the testimony of the witnesses, and the documents and facts stipulated.

Nevertheless, the Referee determined to hear additional evidence which to a great extent merely duplicated that which had been adduced on the 21-a hearings.

On October 31, 1973 the Referee rendered his decision expunging the claim of Pauline Green. (App.P.28) An appeal was thereupon taken to the District Court, which by Order made June 28, 1974, entered July 2, 1974 (Motley, D.J.) affirmed the decision of the Referee. (App. P.27). The bases of these decisions will be herein more fully detailed after an exposition of the facts.

STIPULATION AS TO FACTS

By Stipulation of respective counsel filed with the Court it was agreed that there be deemed in evidence on the motion to expunge:

(a) The examinations of Pauline Green held July 16, 1969, July 30, 1969 and June 21, 1971;

(b) The examination of George Centrella held June 25, 1970;

(c) The Estimated Balance Sheet of the Bankrupt as at June 30, 1968, and the Statement of Income and Expenses for the period January 1, 1968 to June 30, 1968, both prepared by Waxman, Pepper, Gotbetter & Company, Certified Public Accountants.

(d) The report of the examination of the books and records of the Bankrupt as at March 28, 1969 and the analysis thereof prepared for the Trustee by Joseph S. Herbert & Co., Certified Public Accountants.

It was also stipulated that the following facts may be deemed established by the Record:

(a) That the Bankrupt corporation was organized January 27, 1959;

(b) That the Bankrupt's records reflect that Carl Parisi did become a stockholder of record on November 10, 1963, but that such ownership was nominal;

(c) That on July 16, 1968 the Bankrupt received a check in the sum of $17,000. from Pauline Green which check was deposited to the credit of the Bankrupt's bank account, and

(d) That the Bankrupt's books and records presently reflect an indebtedness of $17,000. to Pauline Green as a Loan Payable.

TESTIMONY

In the course of her examinations on July 16, 1969, in the 21-a Proceedings, Pauline Green testified:

That in or about 1967 she had become employed by the Bankrupt as a part-time bookkeeper (SM p.3); that she knew Ernest Roth, the owner of the Bankrupt (SM p. 7) for approximately twenty-five years (Sm p.3); that in the course of her employment she prepared Trial Balances monthly (Sm p.9) and that in July of 1969, the Bankrupt was solvent (Sm p.12).

She further testified that she knew George Centrella for twenty-five years (Sm. p.6) and that since her husband's death, Centrella has handled all her financial matters. (Sm p. 7,11). That after talking it over with Centrella and having been told by him and Roth that she would have nothing to worry about (Sm p. 14) she had, on July 16th, 1968, loaned the Bankrupt corporation $17,000. by her check #233, dated that day, which was deposited in Banrkupt's account (Sm p. 10, 13), and that this loan which was to bear interest at 7-1/2% has not been repaid.(Sm. p.15)

In further testimony on the instant application on October 4th, 1972, the claimant testified again that she had loaned this $17,000. to Madero on July 17, 1969 (Sm p. 10-15)

at interest of 7-1/2% (Sm p. 17), when the bankrupt was paying its factors more than 10% (Sm. p. 17-28); that she would not have made this loan if it had not been guaranteed (SM p.24) that this money went into the corporation account and was used to pay corporate debts (SM p.28), and that after the loan, the bankrupt continued to do business with its factor until the very end. (Sm. p. 29) She also testified that she had turned over certain life insurance proceeds which she received upon the death of her husband to George Centrella, and had been guided by him in all financial matters, and that she would not have made the loan to the bankrupt if Centrella had not told her to do so. (Sm. p. 27).

Centrella, examined on June 25, 1970 in 21-a Proceedings, testified: that he had known Ernest Roth, president of the Bankrupt, since their early youth. That they had worked together in the same business from 1939 to 1950; that gone into business together at that time but that Roth had withdrawn in 1952 (Sm p. 6) That thereafter Roth had on many occasions come to him and discussed his problems (Sm p.3); that in 1958 on Roth's behalf, he had helped reorganize the company in which Roth was then interested, advancing the funds to effect settlement with creditors. (Sm p.5). That in 1963 Roth again came to him with his business problems; that this time Roth, together with one John Mayer, were the principals of Mayer & Roth, Inc., a corporation affiliated with the Bankrupt which was thereafter, but long prior to the Bankruptcy, merged or consolidated with it. (Sm p. 3) Roth then

explained that the corporation was insolvent, overdrawn at the Factors to the extent of $12,000. or $13,000. which was individually guaranteed by him and by Mayer (Sm. p.4). Centrella met with Mayer who consented to withdraw from the corporation conditioned that Mills Factors release him from his personal guarantee,(Sm. p.4) which Centrella then arranged. At Centrella's suggestion, the stock of the corporation was transferred to Carl Parisi, but for Roth's benefit (Sm. p.6,8) Centrella then aided Roth in getting the business restarted by selling the corporation goods at cost. (Sm. p.8) The corporation was operated by Roth completely (Sm. p.10), had its own accountant unaffiliated with the accountant for Centrella's businesses (Sm.p.8), but Roth continued to come to Centrella with any difficulties which arose. (Sm. p.9)

Some time prior to July of 1968 Roth mentioned to Centrella that he was having difficulty paying his bills; that he was overdrawn at the Factors and that he needed about $14,000. or $15,000. (Sm. p.12,13) Centrella stated that he would speak to Pauline Green, whose money he was managing, to lend the corporation $17,000. at 7-1/2%, whereas the Factor was charging 10.6%. (Sm p.13) That after speaking with Pauline Green, and telling her that she would have nothing to worry about, that he "guaranteed" the loan (Sm p.24), she agreed to do so (Sm p.13). He then gave her his personal check for $17,000. (Sm p.32) to evidence that he was paying her a debt which he owed her, and she in turn made the loan to the Bankrupt. (Sm p.33).

Upon his examination on October 4, 1972 Centrella testified substantially as he had in the 21-a Proceedings; that he had handled Pauline Green's business affairs after her husband died and had loaned her and her husband money on at least two occasions, to go into business. (Sm p.33); that Mrs. Green had turned money over to him after her husband died (Sm p.36); that he opened an account for her at Dupont, Glore & Forgan, stock brokers (Sm p.38); that her savings account was in her name and his (Sm p.40); that the brokerage slips from the brokerage account were sent to him (Sm p.40) and that she also has an account with Dreyfus & Co., where duplicate slips do not come to him, but which she turns over to him. (Sm p.40) That in connection with the loan of $17,000. he obtained a check from his sister, Viola Centrella, for that sum (Sm p.45), which he has not repaid (Sm p.46), nor are there any books or records which reflect this transaction (Sm p.47); that he turned this $17,000. over to Pauline Green (Sm p. 47), which she, in turn, loaned to the Bankrupt; that he was never an officer, director or shareholder of the Bankrupt (Sm p. 53), but that he had been authorized to sign corporate checks, having signed one check approximately two weeks prior to the bankruptcy (Sm p.53) and might have had authority at the time when Madero was first formed, as a sort of buffer among the stockholders thereof. (Sm p.54) The one check that he did sign was payment on account of indebtedness due to the petitioning creditor. (Sm p.55)

The other witnesses who testified were Anthony Joanitis, an employee of Dupont, Glore &Forgan, Inc., who stated that all slips and communications respecting an account in the name of Pauline Green are sent to Centrella, at his home in Manhasset, (Sm p.5). Edith Washington, an employee of the Chase Manhattan Bank produced signature cards on the account of Madero Silks, Inc. and stated that she was not familiar with any of the account maintained at the bank. (Sm p.7), but does know Centrella for four years and that he has an excellent reputation. (Sm p.8).

REFEREE'S DECISION

The Referee's decision may be summarized by abstracting therefrom specific comments:

(1) The circumstances surrounding the so-called loan to Madero Silks, Inc. are most unusual; the business of Madero was controlled by George Centrella through his brother-in-law, Carl Parisi, the nominal sole stockholder of the Bankrupt; Centrella was really in charge of its affairs; (App. p. 29).

(2) In making the arrangements for the loan by Pauline Green to the Bankrupt, Centrella borrowed $17,000. from his sister, interest free, which has not yet been repaid; (App. p.29)

(3) Centrella, who for a number of years had been managing the affairs of Mrs. Green pursuaded her to lend the

$17,000. to Madero Silks, Inc., at a time when the corporation was in serious financial difficulties, though at the time Mrs. Green was subsisting on a small salary and Social Security Benefits. (App. P.29).

(4) The Referee does not credit the statement that it was the intention of Pauline Green to loan money to the Banrkupt; on the contrary he infers that George Centrella "intended to cause these funds to be put at the disposal of the corporation in an attempt to sustain it, intending that he could use Pauline Green as a cats-paw to salvage some part of his investment by way of a creditor's claim against any assets of the corporation which might be available in insolvency"; (App. p.29).

(5) Pauline Green was merely the alter ego for George Centrella in investing additional capital in Madero Silks, Inc. and accordingly, the application is granted. (App. p30)

(6) Centrella's position is tainted with deceit, dishonesty and fraud; he is entitled to no aid from this Court of equity. (App. p.30).

DISTRICT COURT'S DECISION

The District Court held that "the Referee's conclusions that the purported 'loan' bore none of the normal indicia of a bona fide loan, and that he did not credit the testimony of Claimant-Appellant that she intended to lend money to the bankrupt, were based in part on his estimate of the credibility of the witnesses", which determinations are entitled to "especial weight." (App. p.27)

CLAIMANT'S CONTENTIONS

Claimant contends that the District Court fell into error when it misread the Referee's decision and concluded that his determinations were issues of fact, rather than issues of law. Claimant further contends that the Referee fell into serious error in determining the issues of law which were presented, and that,

(1) A loan to a corporation, made or arranged by a person found to be in control thereof may be the basis of a valid claim in bankruptcy,

(2) No deceit, dishonesty or fraud is practiced on a corporation or its creditors where such loan is made or arranged in the name of a third party.

(3) Where such loan is made in the tenth year of the corporation's existence, the moneys deposited in the corporate account and used for corporate purposes in the regular course of its business, and the transaction reflected on the books of the corporation, the Court is not warranted in disregarding the loan and concluding that it represents additional capital investment.

(4) Notwithstanding the finding of the Referee that the loan was made or arranged by the person in control of the corporation, the claimant herein is the proper party claimant.

POINT I

THE PROPRIETY OF THE REFEREE'S DECISION DID NOT DEPEND ON HIS DETERMINATION OF ISSUES OF FACT, BUT RATHER ON THE CONCLUSIONS OF LAW WHICH WERE DEPENDENT UPON HIS FINDINGS.

On her appeal to the District Court, claimant was aware and bore in mind the admonition of Bankruptcy Rule §810 which provides that upon an appeal from a decision of a Referee, "The Court shall accept the Referee's findings of fact unless they are clearly erroneous and shall give due regard to the opportunity of the Referee to judge of the credibility of the witnesses."

Claimant then argued not that the Referee's findings of fact were erroneous, but rather than the conclusions of law which he drew therefrom were wrong,and that notwithstanding these findings Claimant was entitled to a denial of the Trustee's motion to expunge her claim, as a matter of law.

The District Court fell into error in arriving at this decision in two respects:

(1) In assuming that the decision below depended upon determinations of issues of fact, rather than on the conclusions of law drawn therefrom and

(2) It misread the decision:

(a) Contrary to the statement contained in the District Court opinion, the Referee's decision did not turn on the lack of "indicia of a bona fide loan". No reference whatever appears in the decision to any such lack.

(b) .The statement in the Referee's decision to the effect that the Claimant did not intend to lend money to the Bankrupt must be read in the context of the complete paragraph

where this statement appears. From such examination it is apparent that the Referee did not determine that no moneys had been advanced to the corporation, but rather that these moneys had been advanced not by the Claimant, but by Centrella, in her name.

POINT II

A LOAN TO A CORPORATION MADE OR ARRANGED BY A PERSON FOUND TO BE IN CONTROL THEREOF MAY BE THE BASIS OF A VALID CLAIM IN BANKRUPTCY.

It is uncontroverted and the record and the decision and order appealed from fully establish that on July 16, 1968 a check of Pauline Green in the amount of $17,000. was deposited in the bank account of the bankrupt, entered on the books of the bankrupt as a "loan payable" to Pauline Green; that this sum was used in the regular course of the corporate business and that the loan remained unpaid at the time of the filing of the petition.

The Referee found that these moneys had actually been advanced by George Centrella, who was in control of the business of the bankrupt, rather than by Pauline Green, with the intention, "to cause these funds to be put at the disposal of the corporation, in an attempt to sustain it, intending that he could use Pauline Green as a cats-paw, to salvage some part of his investment by way of a creditor's claim against any assets of the corporation which might be available in insolvency." (App. p.) It would appear from this quotation that the Referee was of the

opinion that no valid claim in bankruptcy may be made for loans or advances by person or persons in control of a corporate bankrupt,and that there is something sinister and illegal about such controlling person intending to share to the extent of such "loans and advances" over their capital investments with other creditors in the event of corporate bankruptcy. If this is what prompted the Referee's determination, he fell into serious error.

At one time the law was that no valid claim in bankruptcy might be made for loans or advances by persons in control of a corporate bankrupt, but that principle has long since been changed. The transition is reflected in the following excerpt from the dissenting opinion of Hon. Learned Hand, Circuit Judge, in Gilbert v. Commissioner of Internal Revenue, CC 2d 1957, 248 Fed.2d 399, 410, where, by way of obiter dicta, the Judge reviewed the determination of this principle, stating:

> "Whatever may have been the earlier doctrine, it is, I think, now settled that a debt to the holder, or holders, of all shares of a corporation will in case of insolvency be on a parity with debts of outsiders. It is true that in Flynn V.Loewer Realty Co. 2 Circ., 167 F. 2d 318, 320, we said that a sole shareholder who lends money to the corporation, is at an advantage over outside creditors in that he controls the conduct of the enterprise, and is actuated by the hope of more than the return of his principal and interest; but that alone is no reason for imposing upon him a fiduciary relation vis-a-vis other creditors. In any event, whatever may have been the effect of the earlier decisions, in Comstock v. Group of Institutional Investors, 335 U.S.211,229, 68 S. Ct. 1454, 1463, 92 L.Ed.1911, the Supreme Court

declared that some abuse of the shareholder's control must appear before his debt loses its parity with other debts: "In the case before us there was domination of the subsidiary, a relationship between corporations which the law has not seen fit to proscribe. * * * *It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong." Our latest decisions have been in accord with this doctrine, and I can see no distinction between a case of two corporations, one holding all the other's shares, and a corporation and two individuals, who between them hold all its shares and act in common."

The guide lines now controlling the allowance of claims filed by stockholders and corporate officers are stated in 3A Collier On Bankruptcy, §63.06 (5.3) p. 1789.

"(5.3) - Stockholders, Corporate Officers; Interrelated Corporations; Bondholders.

The Courts treat claims of stockholders, corporate officers, and interrelated corporations in much the same way as they deal with claims of close relatives. They hold them allowable where based on honest and bona fide dealings, but they expect the bona fides to be demonstrated beyond cavil and apply in their examination "a large measure of watchfule care". The reason why corporate officers, directors or principal stockholders should not be excluded from having their lawful claims allowed merely because of their close relation to the bankrupt corporation is basically akin to that urging similar benevolence toward claims of relatives; such persons are the ones most interested in restoring and reviving the credit of their corporation and as long as they do not abuse their position and better knowledge to secure to themselves some unlawful preference, neither creditors nor society have reason to look upon their efforts with anything but approval. A stockholder, director or officer may, therefore, not only lend money to his corporation, but may also receive a security for the loan."

The text finds support in many decisions, but it is deemed necessary only to cite the following:

Frasher v. Robinson, CC 9th 1972, 458 F.2d 492, Cert. Denied 409 U.S. 1009.

Small v. Williams, CC 4th 1963, 313 F.2d 39;

Spach v. Bryant, CC 5th 1962, 309 F.2d 886;

Barlow v. Budge, CC 8th 1942, 127 F.2d 440;

Matter of Calpa Products Co., Dist.Ct. Eastern Dist. Pa. 1963, 249 F.Sup. 71, Aff'd 354 F2d 1002, Cert. Denied 383 U.S.947;

In Re Brunner Air Compressor Corp. Dist. Ct. Northern Dist. of N.Y. 1968, 287 F.Sup.256.

These cases and the text cited above also stand for the proposition that such parity may be lost for some inequitable conduct practiced by the controlling stockholder; not the mere existence of an opportunity to do wrong, but some abuse of control to obtain an advantage to the injury of the corporation, and its creditors. (Gilbert v. Commissioner of Internal Revenue, CC 2d 1957, 248 F.2d 399,411, Decision of Learned Hand, Cir.J.); some violation of the rules of fair play and good conscience by the claimant. Such parity may also be lost where it is concluded that the "loans" were necessitated by an initial insufficiency of the bankrupt's equity capital and that the loans were, in effect, contributions to capital. (Braddy v. Randolph CA 4th, 1963, 352 F.2d 80). That neither base will support loss of parity in this instance will be more fully developed in the succeeding points.

POINT III

NO DECEIT, DISHONESTY OR FRAUD IS PRACTICED ON A CORPORATION AND ITS CREDITORS WHERE A LOAN BY A CONTROLLED PERSON IS MADE OR ARRANGED IN THE NAME OF A THIRD PARTY.

In Barlow v. Budge (CC 8th 1942, 127 F.2d 440), the Court set forth a threefold test for the allowance of a claim asserted by a controlling stockholder in the following language:

> "...his relation to the bankrupt will not prevent the allowance of his claim on a parity with other creditors if he can show that the money was needed by the corporation and was used for proper corporate purposes and that the transaction between him and the corporation was open, honest and free from unfairness or fault."

By the standards so fixed, the record establishes that Centrella has met each essential:

1. That the money was needed by the corporation is established by the Estimated Balance Sheet of the Bankrupt as of June 30, 1968 and the State of Income and Expense from January 1 to June 30, 1968, prepared by the Bankrupt's accountants. (Item "c" of documents deemed in evidence pursuant to "Stipulation as to Facts" between counsel.) These reflect that on June 30, 1968 the bankrupt had a Net Worth of $18,407., though its operations from January 1 to June 30, 1968 had resulted in a loss of $14,280. Incidentally, they also establish that the operations for the month of June, 1968 were profitable. The bankrupt was overdrawn at its Factors, which was then charging interest at the rate of 10.6% (Centrella's testimony June 25, 1970, SM p.12 & 13.)

2. The check evidencing the moneys loaned was deposited in the corporate bank account and was used for proper corporate purposes. (Item "C" of "Facts" deemed established by the record in "Stipulation as to Facts" between counsel; testimony of claimant on October 4, 1972. SM p.28)

3. The loan was made on terms beneficial to the bankrupt and its creditors at an interest rate substantially less than that being charged by its Factors in the tight money market of 1968. The sum of $17,000. was afforded the bankrupt for use in its regular operations, including payments to its creditors, which it would not otherwise have had available.

There is nothing in the record which gives rise to the inference that Centrella, though found to be in control of the bankrupt, abused such control to obtain an advantage to himself, as a result of the loan. Some doubt, however, as to the bona fides of the transaction arises from the statement in the Referee's decision that Centrella's position is "tainted with deceit, dishonesty and fraud". No evidence to support any such conclusions appear in the record, nor in the decision itself and Claimant believes that the phrase results from the Referee's misconception of the applicable law, and his belief that if the loan was made by Centrella, a controlling person, then it was not entitled to parity.

This attitude on the part of the Referee is evident from the fact that he permitted the record to be encumbered with much more repititious testimony adduced over the objections of the Claimant, with respect to the relations between Centrella and his sister, and Centrella and the Claimant herein. It was not the relations vis-a-vis these parties that was determinative of the issues presented, but rather the relationship between Centrella and the corporation, and after determining that Centrella had control thereof, whether he had abused such control to obtain an advantage to himself. The misconduct which falls within the maxim must relate directly to the transaction concerning which the complaint is made, or to the subject matter in litigation. (Matter of Kansas City Journal Post Co., 51 Fed. Sup.1009.) aff'd. CCA 8th Dist. 1944, 144 F.2d 791.)

The record on this ultimate issue compels a determination that there was no abuse of this control, for the only benefits accruing from the loan were not to Centrella but to the Bankrupt and its creditors. There is nothing immoral or illegal about Centrella having arranged for the loan to be made in the name of Pauline Green. It gained him no advantage and did not make of the claimant a "cats-paw" to salvage some part of his investment by way of a creditors claim", nor his "alter ego". Under the law as it presently exists no difference resulted whoever became the creditor on the books of the Bankrupt. Whoever advanced the funds had a valid claim in bankruptcy on a parity with claims of other creditors

even though the funds may have been borrowed or obtained from some other source, so long as they did not originate with the borrower, the bankrupt itself.

POINT IV

WHERE SUCH LOAN IS MADE IN THE TENTH YEAR OF THE CORPORATION's EXISTENCE, THE MONEYS DEPOSITED IN THE CORPORATE ACCOUNT AND USED FOR CORPORATE PURPOSES IN THE REGULAR COURSE OF ITS BUSINESS, AND THE TRANSACTION REFLECTED ON THE BOOKS OF THE CORPORATION, THE COURT IS NOT WARRANTED IN DISREGARDING THE LOAN AND CONCLUDING THAT IT REPRESENTS ADDITIONAL CAPITAL INVESTMENT.

Whether a particular transaction constitutes a loan or a capital contribution is a problem which seldom arises in bankruptcy, but quite often under the Income Tax Laws. The principles which govern the determination in each instance are quite different. Under the Internal Revenue laws, the determination of this issue has serious tax consequences. (Gilbert v. Commissioner of Internal Revenue, 248 F.2d 399,402, Opinion of Medina, C.J.)

(a) Interest on indebtedness is deductible, (IRC 1954 §163(a);) dividends are not;

(b) Where the corporation becomes insolvent, a loan is allowed in full as either a business bad debt or short term capital loss whereas a capital contribution is limited to a capital loss upon worthless stock. (IRC 1954 §166 (a).

To prevent the abuse of the tax advantages flowing from a loan as compared to a capital contribution the "thin" corporation rule was adopted. This rule has been referred to as an

"exercise in administrative invention and judicial legislation which has generated intolerable confusion". (3 Rabkin & Johnson, Federal Income Gift and Estate Taxation §35.08(4). With the hope of shedding some light on the conflicting decisions of the several circuits applying the rule, Section 385 of the Internal Revenue Code was added by the Tax Reform Act of 1969. This section authorized the Secretary of the Treasury or his delegate to "prescribe regulations as may be necessary or appropriate to determine whether an interst in a corporation is to be treated for the purposes of this title, as stock or indebtedness".

As of this date the Treasury Department has not prescribed any regulations under the section, and the same confusion which existed prior to its adoption still prevails. In this Circuit there is recognition of the principle that capitalization is a matter of the taxpayer's free decision so long as the debts are valid, comply with arms-length standards and are not a patent distortion of normal business practice. (4 Research Institute "Tax Coordinator"§K-5106; Nassau Lens Co. vs Commissioner 308 Fed.2d 39, Gilbert vs. Commissioner, 248 Fed.2d 399.)

The issue of "loan or capital contributions" in bankruptcy involves the right of the alleged creditor to share with other creditors of the same class. The determination thereof depends on whether there was an original insufficiency of capital. (Braddy v. Randolph, CA 4th,352 Fed.2d 80.), or inequitable conduct.

The distinction between a "thin corporation" under the revenue statutes and in bankruptcy was clearly recognized in Judge Learned Hand's decision in Gilbert v. Commissioner, Supra,

wherein the Judge pointed out that if the stockholders there did, in fact, mean to make their advances debts of the corporation, there was nothing to defeat their purpose, but "it is also settled that, although the rights of a taxpayer may be absolute as between himself and his corporation, the law will at times refuse to regard those rights in assessing his income tax." (248 Fed.2d at p.411).

The distinction is more clearly delineated in Rowan vs. U.S., 219 Fed.2d 51,54, 5th Cir.1955, where the Court stated:

> "Many students of tax law have discussed the inadequately capitalized corporation, sometimes popularly known as the "thin corporation". The Court, of course, recognizes the fact that stockholders who lend money to their own corporation obtain all the advantages of favorable tax treatment if the enterprise fails. But the court also recognizes that, entirely without reference to the incidence of taxes, stockholders of corporations have always been free to commit to corporate operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intend, always thus reserving the right to share with other creditors a distribution of assets if the enterprise fails. It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation. No stockholder could safely advance money to strengthen the faltering steps of his corporation (which, of course, may be greatly to the benefit of other creditors) if he is faced with the danger of having the Commissioner with the backing of the course, say, "he had no right to launch a corporate business without investing in it all the money it needed, and investing it in the way that is most disadvantageous to himself,both as relates to taxation and as to other creditors." (emphasis added)

The record is barren of any evidence as to the capital investment made in the bankrupt when it was first organized in 1959. It must have been sufficient to sustain its operations, at least to June of 1968, for a period of more than nine years, at which time the corporation still had an estimated Net Worth of $18,407. The loan of $17,000. was made in July, 1968; the moneys deposited in the corporate bank account and used in the regular course of its business, with the transaction reflected on its books. It was proper for the Court to "infer that George Centrella intended to cause these funds to be put at the disposal of the bankrupt corporation in an attempt to sustain it." But, it does not follow from this premise that the "loan" must then be considered a capital contribution. In view of the lapse of more than nine years from the original organization and the date of the loan here a finding of "insufficiency of original capital" is impermissable,as a matter of law. When the Referee concluded to the contrary he fell into serious error.

POINT V

NOTWITHSTANDING THE FINDING OF THE REFEREE THAT THE LOAN WAS MADE OR ARRANGED BY CENTRELLA, THE CLAIMANT-HEREIN IS THE PROPER PARTY CLAIMANT.

Usually the legal owner of a claim, who would have been entitled to maintain suit thereon, is the person who should make the proof of the claim, and he may do so despite the fact that another is beneficially or equitably interested therein. (3 Collier on Bankruptcy, §57.05,p.136) . Even though then the Referee held that the loan was made by Centrella in the name of the claimant, herein, she is the proper party claimant.

CONCLUSION

The Order of District Court, dated June 28, 1974, and entered July 2, 1974, and the Order of the Bankruptcy Referee dated October 31, 1973, should be reversed and the Trustee's motion to expunge the claim of PAULINE GREEN for moneys lent to the bankrupt should be denied.

Dated: September 13, 1974

Respectfully submitted,

KAPLAN & ABRAHAMS, P.C.
Attorneys for Claimant-
Appellant
200 Garden City Plaza,
Garden City, New York 11530

DOCKET ENTRIES IN BANKRUPTCY COURT

NAME OF BANKRUPT/DEBTOR (Last / First / Middle)

NADERO SILKS, INC.

~~NADERO SILKS, INC.~~

ADDRESS OF BANKRUPT/DEBTOR (Number and Street)

114 East 32nd Street

CITY: New York | ZONE: | COUNTY: New York | STATE: NY

DIST. NO.: 208 | DIV. NO.: | DOCKET NO.: 69 B 11[illegible]

CHAPTER OR SECTION: 4

DATE PETITION FILED: Feb 27-69

CHECK IF: [ ] Voluntary [X] Involuntary [ ] Fee paid in installments [X] Corporation

DATE CLOSED:

DISCHARGE: [ ] Granted [ ] Denied [ ] Waived or not applied for

DATE DISCHARGED:

OCCUPATION (Check one): [ ] Farmer [ ] Employee [ ] Professional [ ] Other (Non-business) [ ] Merchant [X] Manufacturer [ ] Other Business

PETITION DISMISSED? [ ] YES | DATE DISMISSED: | CHAPTER UNDER WHICH CASE WAS PENDING WHEN DISMISSED:

NAME OF JUDGE:

NAME OF REFEREE: Edward J. Ryan

	TOTAL	PRIORITY	SECURED	UNSECURED
NO ASSET CASES ONLY / CLAIMS AS SCHEDULED	$	$	$	$

	NAMES AND ADDRESSES
ATTORNEY FOR BANKRUPT OR DEBTOR	
ATTORNEY FOR PETITIONING CREDITORS	Sherman & Citron, 1290 Avenue of the Americas, New York, N.Y. 10019 (LT 1-8900)
RECEIVER	Mrs. Mary Johnson Lowe 501 E. 161st Street, Bronx, N.Y.
ATTORNEY FOR RECEIVER	
TRUSTEE	
ATTORNEY FOR TRUSTEE	

CHANGES OF PRINCIPALS

DATE	PROCEEDINGS
Feb 27-69	Filed involuntary petition - referred to Referee Ryan.
3-20-69	Copy Notice [illegible]
Mar 28-69	Filed schedules and statement of affairs in trip. - dlvd. 2 to Referee.
Apr 2-69	Filed petition and order appointing MRS. MARY JOHNSON LOWE Receiver, bond $500.00 and enlarging her duties and compensation pursuant to R.O. 40 - Cooper, J. (notified referee)
Apr 4-69	Filed receivers bond - $500.00 - U.S. Fidelity and Guaranty Co. (notified referee)
Apr. 8-69	Filed certified copy of referee's order of adjudication.

FORM BK 74-D
SEP. 1962

UNITED STATES DISTRICT COURTS
BANKRUPTCY DOCKET – COPY

[ ] CHECK THIS BOX IF FILING FEES WERE PAID IN FULL AT TIME OF FILING

DOCKET ENTRIES IN BANKRUPTCY COURT

69 B 149 EJR
LOCKET NUMBER

MADERO SILKS, INC.

	DATE	PROCEEDINGS
	1974	
	1/18/74	Filed by attorneys for claimant-appellant (Mary Johnson Lowe), appellant's brief.
	1/18/74	Filed affidavit of service by attorneys for claimant appellant (Mary Johnson Lowe).
(2)	3/4/74	Order signed removing Mary Johnson Lowe as trustee and tha Michael Wexelbaum of 1290 Avenue of the Americas, NYC be substituted and that the amount of th e bond is $15,000.00
	3/6/74	Filed trustee's bond.
(3)	3/6/74	Order signed approving trustee's bond. Mailed true copies to trustee.
(4)	3/11/74	Order signed authorizing trustee to retain Sherman & Citron as his attorneys.
	3/12/74	Filed reply brief of claimant-appellant Pauline Green.
	4/18/74	Send notice of appeal to District Court on 2/8/74. Re: Pauline Green.
(5)	5/30/74	Order signed authorizing transfer of funds of estate to time certificates of deposit or time deposits-open account
	7/3/74	Received from the Clerk of the Court endorsement signed by U.S.D.J. Constance Baker Motley on June 28, 1974. Re:Affirming the decision of Judge Ryan granting the motion of the trustee-Appellant in bankruptcy to expunge claim of claimant-Appellant, Pauline Green.

DOCKET ENTRIES IN BANKRUPTCY COURT

2/13/74 Received from Bankruptcy Judge.NOTICE OF APPEAL TO DISTRICT COURT, from the Order of Bankruptcy Judge,entered on:10/31/73.,ETC. RET. TUESDAY MARCH 26th,1974 at 10:30 A.M. in Room 506.BRN.FOLDER

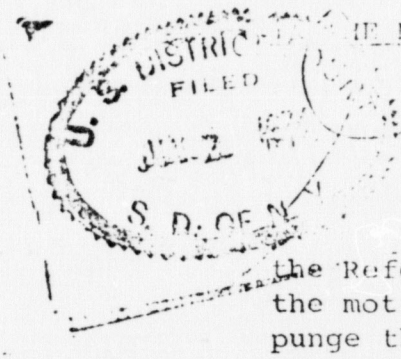
3/1/74 Filed Brief of Trustee-Appellee. Submitted by: SHERMAN & CITRON, attorneys for Trustee-Appelee.

7/2/74 Filed ENDORSEMENT (on back of Notice of Appeal,Dated:2/13/74) .....This is a petition to review the decision of Hon.Edward J. Ryan which granted the motion of the trustee-Appellee in Bankruptcy to expunge the claim of Claimant-Appellant,Pauline Green in the bankruptcy proceeding of Madero Silks,Inc.,...The decision of the Referee is, therefore affirmed.JUDGE MOTLEY,DATED:6/28/74. COPY TO BANKRUPTCY JUDGE,RYAN.SEE ENDORSEMENT FOR FULL DETAILS. BROWN FOLDER RETURNED.

7/29/74 Filed Notice of Appeal from the Order of the District Court dated June 28, 1974. Copy mailed to SHERMAN & CITRON ESQS., Attys for the Trustee-Appellee, 1290 Avenue of the Americas, N.Y. N.Y, 10019.

ORDER OF DISTRICT COURT AFFIRMING DECISION OF REFEREE

HON. Edward J. RYAN



FILED - S

JUL 3 1974

EDWARD J. RYAN
BANKRUPTCY JUDGE

IN THE MATTER OF MADERO SILKS, INC., 69 B 149

ENDORSEMENT

This is a petition to review the decision of the Referee in Bankruptcy (Edward J. Ryan) which granted the motion of the Trustee-Appellee in Bankruptcy to expunge the claim of Claimant-Appellant, Pauline Green in the bankruptcy proceeding of Madero Silks, Inc.

The basis of Claimant-Appellant's claim was a purported loan to the bankrupt corporation made on July 18, 1968. The Trustee-Appellee contends that the money so paid should be characterized as "additional paid-in-capital", rather than a "loan", and as such it is not a valid claim.

This court finds that the facts and conclusions found by the Referee are adequately sustained by the hearings, documents and facts stipulated to by the respective attorneys in this case. Importantly, the Referee's conclusions that the purported "loan" bore none of the normal indicia of a bona fide loan, and that he did not credit the testimony of Claimant-Appellant that she intended to lend money to the bankrupt were based in part on his estimate of the credibility of the witnesses. Such determinations are entitled to "especial weight." In the Matter of Mimshell Fabrics, Ltd., ___ F.2d ___, Docket No. 72-1804 (2d Cir., decided January 25, 1974) (slipsheet p. 1622). The decision of the Referee is, therefore, affirmed.

Dated: New York, New York

June 28, 1974

SO ORDERED

Constance Baker Motley

CONSTANCE BAKER MOTLEY
U. S. D.J.

DECISION & ORDER OF REFEREE ON TRUSTEE'S APPLICATION FOR AN ORDER EXPUNGING THE CLAIM OF PAULINE GREEN, AND FOR ALTERNATIVE RELIEF.

Before: Honorable Edward J. Ryan,
Referee in Bankruptcy.

Madero Silks, Inc., a corporation engaged in the business of furnishing print fabrics for the necktie industry was adjudicated bankrupt on an involuntary petition filed against it on February 27, 1969. At the first meeting of creditors, held on April 24, 1969, Mary Johnson Lowe was appointed trustee in bankruptcy. In due course in the administration of the estate, the trustee filed objections to the claim filed by one Pauline Green. The basis of this claim is a purported loan to the corporation made by Mrs. Green on July 18, 1968. By application dated April 19, 1971, the trustee contends that Mrs. Green's claim is not a valid claim against the estate in that, among other things, it should be deemed additional paid-in capital or, in all the circumstances of this case, subordinated to the claim of the other general unsecured creditors.

In a responsive pleading dated April 23, 1971, Mrs. Green denies the substance of the trustee's contentions, and in addition accuses the trustee of laches because "the trustee refrained from instituting these proceedings for more than 20 months after the filing of the proof of claim herein . . . " The affirmative defense is dismissed for insufficiency on its face. There is no evidence in the record to show that the delay was unreasonable, and it does not appear that the claimant has been prejudiced in any way by reason of the delay.

The circumstances surrounding the so-called loan to Madero Silks, Inc. are most unusual. Similarly, the manner in which the corporate affairs were conducted was entirely unorthodox. The eminence grise who emerged from the testimony and other evidence adduced was one George Centrella. Mr. Centrella controlled the business of Madero Silks through his brother-in-law Carl Parisi, the nominal sole stockholder of the bankrupt. It was shown at the trial that Mr. Centrella really was in charge of the affairs of Madero Silks, Inc. In making the arrangements for the "Loan" by Pauline Green to the bankrupt in July of 1968, Centrella states that he borrowed the sum of $17,000. from his sister, Viola Centrella. The loan had not yet been repaid when he testified, and it was an interest=free "Loan" from his sister.

Mrs. Green and Mr. Centrella both testified in substance that for a number of years he had been managing the affairs of Mrs. Green, and that it was he who had pursuaded Mrs. Green to lend the sum of $17,000. to Madero Silks, Inc. at a time when that corporation was in serious financial difficulties. When Mrs. Green purported to lend this substantial sum of money to the failing corporation, she was subsisting on a salary of $30. a week and benefits from Social Security.

I do not credit the testimony that it was the intention of Pauline Green to lend money to Madero Silks, Inc. as contended by her. To the contrary, I infer that George Centrella intended to cause these funds to be put at the disposal

of the corporation in an attempt to sustain it, intending that he could use Pauline Green as a cat's paw to salvage some part of his investment by way of a creditor's claim against any assets of the corporation which might be available in insolvency.

Pauline Green was merely the alter ego for George Centrella in investing additional capital in Madero Silks, Inc. Accordingly, the application of the trustee to expunge the claim of Pauline Green is granted.

Mr. Centrella asserts the argument that even if we assume that he in fact, made this loan, the trustee's application should be denied, relying upon language in 3A Collier on Bankruptcy, 14th ed. ¶63.06 [5.3] and on the rule enunciated in Barlow v. Budge, (8th Cir. 1942), 127 F. 2d 440.

The authorities relied upon by Mr. Centrella do not aid him, being clearing distinguishable from the circumstances in which he now seeks to be deemed a creditor of this bankrupt. It suffices to refer to the language quoted by Mr. Centrella from Barlow v. Budge, supra, requiring that an insider show that ". . .the transaction between him and the corporation was open honest and free from unfairness or fault." (emphasis supplied). Mr. Centrella's position is tainted with deceit, dishonesty and fraud; he is entitled to no aid from this court of equity.

The claim of Pauline Green is expunged. It is so ordered.

Dated: New York, New York
October 31, 1973

S/ EDWARD J. RYAN

Referee in Bankruptcy

UNITED STATES COURT OF APPEALS:SECOND CIRCUIT

Index No.

GREEN,

Claimant-Appellalnt,

against

LOWE,

Trustee-Appellee,

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK ss.:

I, Victor Ortegá, being duly sworn,

deposes and says that deponent is not a party to the action, is over 18 years of age and resides at

1027 Avenue St. John, Bronx, New York

That on the 19th day of September 1974 at 1290 6th Ave., New York

deponent served the annexed Appellant's Brief and Appendix upon

Sherman & Citron

the in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the Attorney(s) herein,

Victor Ortega

Print name beneath signature

VICTOR ORTEGA

Sworn to before me, this 19th day of September 19 74

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, STATE OF NEW YORK
NO. 31 - 0418950
QUALIFIED IN NEW YORK COUNTY
COMMISSION EXPIRES MARCH 30, 1975